

ABA RPPT/Tax Section Joint Meeting — San Francisco
Friday, September 16, 2005

Program of Employee Benefit Plans and Other Compensation Arrangements Group
Summary of Nonqualified Deferred Compensation Plan Provisions
of Section 409A of Internal Revenue Code and IRS Notice 2005-1

Timing of Initial Election:

- General Rule: Initial election to defer compensation and elect time and form of payment must be made prior to the taxable year in which the services are to be performed or at such other time provided in regulations
- New Participants: Initial election may be made within 30 days after becoming eligible to participate with respect to services to be performed subsequent to the election
- Performance-Based Compensation: Initial election may be made no later than 6 months before end of performance period (performance period must be at least 12 months)

Subsequent Elections:

Subsequent elections to delay payment or change form of payment:

- (1) May not take effect until at least 12 months after the election is made
- (2) In the case of payment upon separation from service, at a specified time or pursuant to a fixed schedule or upon change in control, the election must delay payment at least 5 years beyond the originally scheduled date
- (3) In the case of payment at a specified time or pursuant to a fixed schedule, the election must be made at least 12 months before the first scheduled payment

Events Permitting Distributions:

Distributions may be made only upon:

- (1) Separation from service (6 months after separation from service for key employees of public companies)
- (2) Disability

- (3) Death
- (4) Specified time (or pursuant to fixed schedule) fixed at time of initial deferral election
- (5) Unforeseeable emergency resulting in severe financial hardship (limited to the amount necessary to satisfy the emergency and pay taxes)
- (6) Change in ownership or effective control of company or in ownership of substantial portion of assets of company, but only as permitted by regulations

No Acceleration:

No acceleration of time or schedule of any payment allowed unless permitted by regulations

No Restrictions on Investment Options:

Section 409A does not include any restrictions on investment options

Penalty for Failure to Comply with Deferred Compensation Rules:

Immediate taxation of all vested deferred amounts but only with respect to compensation deferred under the plan for participants with respect to whom the failure relates. The tax is increased by interest at the underpayment rate plus 1% from the later of time of original deferral or vesting as well as a penalty equal to 20% of the compensation included in income.

Offshore Rabbi Trusts:

Assets set aside in an offshore trust for the purpose of paying nonqualified deferred compensation are treated as Internal Revenue Code §83 compensatory transfers (i.e., taxed when vested) at the time set aside or transferred outside the U.S. Increases in the value of, and earnings on, such assets are treated as additional §83 transfers. However, this rule does not apply to trust assets located in a foreign jurisdiction if substantially all of the services to which the deferred compensation relates are performed in that foreign jurisdiction. The tax is increased by interest at the underpayment rate plus 1% from the later of the time of original deferral or vesting as well as a penalty equal to 20% of the amount included in income.

Financial Health Trigger in Rabbi Trust:

Assets are treated as transferred for purposes of Internal Revenue Code §83 (i.e., taxed when vested) if a nonqualified deferred compensation plan provides that as-

sets will become restricted to benefit payments if the employer's financial health changes or if assets are so restricted. Increases in the value of, and earnings on, such assets are treated as additional §83 transfers. The tax is increased by interest at the underpayment rate plus 1% from the later of the time of original deferral or vesting as well as a penalty equal to 20% of the amount included income.

Effective Date:

The new rules are effective for amounts deferred after December 31, 2004. An amount is considered deferred before January 1, 2005 if it is earned and vested before that date. Amounts deferred before January 1, 2005 will be subject to the new rules if the plan pursuant to which the deferrals were made is materially modified after October 3, 2004 (except as provided in guidance to be issued by the IRS to allow termination of outstanding deferral elections with respect to amounts deferred after December 31, 2004 or to conform with the new rules).

Internal Revenue Service Notice 2005-1:

The Treasury Department and the Internal Revenue Service issued Notice 2005-1 providing guidance concerning the transitional rules under Section 409A of the Internal Revenue Code for nonqualified defined compensation plans. There follows a brief summary of some of the principal features of such guidance.

1. Short-Term Deferrals: A deferral of compensation does not occur if, absent an election to otherwise defer the payment to a later date, at all times the terms of the plan require payment by, and payment is actually or constructively received by, the later of: (i) 2½ months after the end of the service provider's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture or (ii) 2½ months after the end of service recipient's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.
2. Nonstatutory Stock Options: Nonstatutory stock options may be considered a deferral of compensation unless all of the following conditions are met: (i) the option exercise price may never be less than the fair market value of the underlying stock on the date of grant, (ii) the receipt, transfer or exercise of the option is subject to tax under Internal Revenue Code Section 83, and (iii) the option does not include any feature for deferral of compensation (other than deferral until exercise or disposition).
3. Statutory Stock Options: Statutory stock options (i.e., incentive stock options under Internal Revenue Code Section 422 and options under an employee stock purchase plan described in Internal Revenue Code Section 423) do not constitute a deferral of compensation.
4. Stock Appreciation Rights: Stock appreciation rights (SARs) may be considered a deferral of compensation unless all of the following conditions are met: (i) the value of the stock the excess over which is payable upon exercise of the

SAR may never be less than the fair market value of the underlying stock on the date of grant, (ii) the stock subject to the SAR must be traded on an established securities market, (iii) the SAR may be settled only in such traded stock, and (iv) the SAR does not include any feature for the deferral of compensation (other than deferral until exercise of the SAR). However, until further guidance is issued by the IRS, if SARs are granted pursuant to a program in effect on or before October 3, 2004, such SARs will not be considered deferred compensation even if they may be settled in cash and/or cover stock that is not traded on an established securities market, provided the conditions in (i) and (iv) of the preceding sentence are met.

5. Partnership Interests: Section 409A generally does not apply to the issuance of a capital or profits interest in a partnership in connection with the performance of services.

6. Substantial Risk of Forfeiture: For purposes of Section 409A, compensation is considered subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services or the occurrence of a condition related to the purpose of the compensation, and the possibility of forfeiture is substantial. Any addition of a substantial risk of forfeiture after the beginning of the service period to which the compensation relates, or extension of the period of the substantial risk of forfeiture, is disregarded.

7. Aggregation of Plans: All compensation deferred under account balance plans is treated as deferred under a single plan. All compensation deferred under nonaccount balance plans is treated as deferred under a single plan. All compensation deferred under plans that are neither account balance plans nor nonaccount balance plans (e.g., discounted stock options, stock appreciation rights and other equity-based compensation) is treated as deferred under a single plan. This aggregation rule is significant since, if there is a failure to comply with Section 409A with respect to a participant, all vested deferred amounts under the applicable plan for that participant become taxable (plus interest and penalties).

8. Change of Control: Under Section 409A, a plan may permit payment upon the occurrence of a change in the ownership of the corporation, a change in effective control of the corporation or a change in the ownership of a substantial portion of the assets of the corporation. Each of these terms is defined in detail in Notice 2005-1. A change in ownership occurs if a person or persons acting as a group acquire more than 50% of the total fair market value or total voting power of the stock of the corporation. A change in effective control occurs if (i) a person or persons acting as a group acquire ownership of stock possessing 35% or more of the total voting power or (ii) a majority of members of the corporation's board of directors is replaced during any 12-month period by directors whose appointment or election is not endorsed by a majority of the prior members of the board. A change in ownership of a substantial portion of a corporation's assets occurs if a person or persons acting as a group acquire assets from the corporation that have a total gross fair market value equal to or more than 40% of the total

gross fair market value of all the assets of the corporation immediately prior to such acquisition or acquisitions.

9. Good Faith Compliance: A plan adopted before December 31, 2005 will not be treated as violating Section 409A if it is operated in good faith compliance with Section 409A and Notice 2005-1 during calendar year 2005 and is amended on or before December 31, 2005 to conform to the provisions of Section 409A with respect to amounts subject to Section 409A.

10. Payment Elections: With respect to amounts subject to Section 409A, the plan may be amended to provide for new payment elections (consistent with the distribution provisions of Section 409A) with respect to amounts deferred prior to the election without violating Section 409A, provided that the plan is so amended and the participant makes the election on or before December 31, 2005.

11. Cancellation of Deferral Elections By December 31, 2005: A plan adopted before December 31, 2005 may be amended to allow a participant to terminate participation in the plan or cancel a deferral election and receive deferred amounts without causing a violation of Section 409A provided the amendment is enacted and effective on or before December 31, 2005 and the amounts subject to termination or cancellation are included in income by the participant in calendar year 2005 or, if later, the taxable year in which the amounts are earned and vested. Allowing such an election would not cause a participant who continues to defer to be in constructive receipt of the deferred amounts.

12. Deferral Elections On or Before March 15, 2005: Notice 2005-1 allowed an election to be made on or before March 15, 2005 with respect to deferrals subject to Section 409A that relate to services performed on or before December 31, 2005 without violating the timing requirements of Section 409A or triggering constructive receipt, provided (i) the amounts to which the deferral election related had not been paid or become payable at the time of the election, (ii) the applicable plan was in existence on or before December 31, 2004, (iii) the deferral election was made in accordance with the terms of the plan in effect on or before December 31, 2005, (iv) the plan is otherwise operated in accordance with Section 409A with respect to deferrals subject to Section 409A and (v) the plan is amended by December 31, 2005 to comply with Section 409A.

13. Bonuses: A deferral election with respect to bonus compensation based on services performed over a period of at least 12 months will be treated as meeting the timing requirements of Section 409A if the election is made at least 6 months before the end of the service period. For this purpose (and until further guidance is issued), the term bonus compensation refers to compensation where (i) the payment of the compensation or the amount of the compensation is contingent on the satisfaction of organizational or individual performance criteria (which may be subjective in some circumstances) and (ii) the performance criteria are not substantially certain to be met at the time a deferral election is permitted.

14. Payments Tied To Elections Under Qualified Plans: For periods ending on or before December 31, 2005, an election as to the timing and form of payment under a nonqualified deferred compensation plan that is controlled by a payment election made by the participant under a qualified plan will not violate Section 409A, but only if the determination of the timing and form of payment is made in accordance with the terms of the nonqualified deferred compensation plan as of October 3, 2004 that govern payments.